Internal Revenue Service
memorandum

CC:TL-N-318-92
FS:FI&P:JEHelke

date: DEC 1 3 1991

to: District Director, Chicago EX:MW
Attn: Exam Group 809-Westmont

from: Assistant Chief Counsel (Field Service) CC:FS

---

subject: [redacted]
LYONS - Accrual and deductibility of interest

ISSUE

Whether [redacted] properly accrued and deducted interest on liquid yield option notes (LYONS) pursuant to I.R.C. §§ 163 and 1272.

CONCLUSION

[redacted] properly deducted interest on the LYONS and did not suffer cancellation of indebtedness income on their conversion.

FACTS

[redacted] issued, in [redacted], $[redacted] in principal amount LYONS due [redacted]. At the time of issuance, the LYONS were subordinated debt with a yield to maturity of [redacted] percent. Each note had a face value of $[redacted], was marketed for a price of $[redacted], and was convertible into [redacted] shares of [redacted] common stock.

The indenture states that conversion of the LYON, that portion of accrued original issue discount (OID) attributable to the period from the date of issue to the conversion date was deemed paid to the holder through the exchange of the [redacted] common stock for the LYON.

The prospectus informed the purchasers that daily portions of OID must be included in income for each day of a taxable year (or portion thereof) in which the holder has the LYON.

For the taxable years ended [redacted], and [redacted], [redacted] claimed deductions for accrued OID under I.R.C. § 163(e) in the amounts of $[redacted] and $[redacted], respectively, with respect to the LYONS. The revenue agent's report raised no objection as to the correct calculation of OID under I.R.C. §§ 163(e) and 1272.

009500

The revenue agent's report denied the interest deduction since no cash was actually paid.

DISCUSSION

I.R.C. § 163(a) allows as a deduction all interest paid or accrued within the taxable year on indebtedness. I.R.C. § 163(e)(1) provides that the portion of the OID which the issuer may deduct with respect to a debt instrument in any given year is equal to the sum of the "daily portions" of OID for days during such taxable year. I.R.C. § 163(e)(2)(C) incorporates the definition of "daily portions" from section 1272(a)(3) which determines the "daily portions" by allocating to each day of the "accrual period" a pro rata portion of an amount equal to the adjusted issue price of the note at the beginning of the accrual period multiplied by the yield to maturity of the note for such accrual period less [certain] interest payments.

I.R.C. § 1273(a)(1)(A) and (B) define OID as the excess of the stated redemption price at maturity of a debt instrument over the issue price of that debt instrument. The question then, is whether OID on convertible debt may be properly deducted. Treas. Reg. § 1.163-4(b) gives two examples:

> (b) Examples. The rules in paragraph (a) of this section are illustrated by the following examples:
>
> Example (1). N Corporation, which uses the calendar year as its taxable year, on January 1, 1970, issued for $99,000, 9 percent bonds maturing 10 years from the date of issue, with a stated redemption price at maturity of $100,000. The original issue discount on each bond (as determined under section 1232(b)(1) without regard to the one-fourth-of-1-percent limitation in the second sentence thereof) is $1,000, i.e., redemption price, $100,000 minus issue price, $99,000. N shall treat $1,000 as the total amount to be amortized over the life of the bonds.
>
> Example (2). Assume the same facts as example (1) except that the bonds are convertible into common stock of N Corporation. Since the issue price of the bonds includes any amount attributable to the conversion privilege, the result is the same as in example (1).

We have no information showing that the conversion feature of the LYONS was not included in determining the issue price. In short, convertible debt is to be treated the same as nonconvertible debt for purposes of determining the amount and timing of the issuer's OID deduction.

The next question is whether a corporation may satisfy its liability to pay interest through the issuance of its own stock. In this context, there is a question as to whether any accrued interest is lost upon conversion. The terms of the indentures must be reviewed.

Rev. Rul. 68-170, 1968-1 C.B. 71, held that where the terms of a bond indenture provided that a bondholder who converted his bond prior to an interest payment date would lose the interest accruing from the previous interest payment date, the accrual basis issuer could not deduct interest accrued from the previous interest payment date to the date of conversion, even if the value of the stock into which the bond was converted exceeded the value of the bond by the amount of the accrued interest. Rev. Rul. 74-127, 1974-1 C.B. 47, analyzed debentures that provided "that upon conversion of the debenture between interest payment dates, no interest will be payable for such period." Rev. Rul. 74-127 stated that since the issuer in Rev. Rul. 68-170 had no liability to pay interest until the next payment date, no interest accrued between payment dates. Rev. Rul. 74-127 concluded that under the rules of accrual accounting set forth in Treas. Reg. § 1.461-1(a)(2), "all events" which fix the issuer's liability to pay interest have not occurred until the holder holds the bond until the next interest payment date. Accordingly, the revenue ruling held that the issuer may not deduct interest until the next payment date.

Rev. Rul. 68-170 stated that the fact that the "stock into which the bond was converted had a value greater than the bond at the time of conversion has no relevancy to the determination" of the issuer's interest deduction. The courts have reached the same conclusion on substantially the same facts in Bethlehem Steel Corporation v. United States, 434 F.2d 1357 (Ct. Cl. 1970); Scott Paper Company v. Commissioner, 74 T.C. 137 (1980); Tandy Corp. v. United States, 626 F.2d 1186 (5th Cir. 1980); and Husky Oil Co. v. Commissioner, 83 T.C. 717 (1984), aff'd sub nom, Marathon Oil Co. v. Commissioner, 838 F.2d 1114 (10th Cir. 1987).

Rev. Rul. 68-170, Rev. Rul. 74-127, and the above cited cases describe convertible obligations where the indentures were ambiguous as to whether interest accrued between interest payment dates. The indenture in Scott Paper stated that:

> the interest on the coupon Debentures becoming payable on or prior to the maturity of the Debentures shall be payable only upon presentation and surrender of the several coupons for such interest installments as are evidenced thereby and <u>as such coupons mature</u> . . . . No adjustment or payment is to be made on conversion for interest accrued hereon or for dividends on securities issued on conversion.

74 T.C. at 139, 140. The indentures in <u>Bethlehem Steel</u>, <u>Tandy</u> and <u>Husky Oil</u> had a similar "no adjustment" clause. The issuers argued that the holders of the convertible bonds converted only if the value of the stock they received exceeded the principal amount of the bond plus accrued interest. The Tax Court in <u>Scott Paper</u> and <u>Husky Oil</u>, the Fifth Circuit in <u>Tandy</u>, and the Court of Claims in <u>Bethlehem Steel</u> concluded that the language in the debenture meant that the issuers' liability to pay interest arose only on the payment date specified, that the issuers had no liability to pay interest on bonds converted between payment dates, and consequently that no deduction was allowed for accrued interest with respect to bonds converted between interest payment dates. The court in <u>Bethlehem Steel</u> discussed the ambiguity of the language in the debenture and stated that the drafter (issuer) should be responsible. The ambiguity was interpreted adverse to the issuer.

In the present case, the indenture for the issue of LYONS specifically provides for deemed payment of accrued OID from the period of the date of issue to the conversion date. (Indenture dated [redacted], [redacted]). The revenue rulings and cases discussed above indicate that interest on debt may be deducted and satisfied through the issuance of stock by the issuer as long as the terms of the debt clearly state that interest accrues to the date of conversion and is paid. Since the debt so states in this case, [redacted] is entitled to the interest deductions at issue.

The final argument which could be made to deny [redacted] these interest deductions is that the exact value of the stock cannot be determined on the date of issue. The question is what mechanism assures that the issuer is not relieved of a portion of its obligation to pay interest.

The concern that a corporate issuer may accrue more OID than the value of the stock given up on conversion and, therefore, be relieved of a portion of its obligation to pay interest, is addressed in the Code and regulations. I.R.C. § 61(a)(12) includes in income from the discharge of indebtedness.

Treas. Reg. § 1.61-12(c)(3) states that:

> If bonds are issued by a corporation and are subsequently repurchased by the corporation at a price which is exceeded by the issue price plus any amount of discount already deducted, . . . the amount of such excess is income for the taxable year.

The rule treats accrued and deducted OID as an addition to principal for purposes of calculating cancellation of indebtedness income. The rule makes no distinction for convertible bonds.

I.R.C. § 108(e)(10)(A) requires a corporate issuer of debt which reacquires its debt obligations in exchange for its own stock to determine its income on the transaction as if it had repurchased the debt obligations for an amount of cash equal to the fair market value of the stock issued in exchange for the bonds.

Treas. Reg. § 1.61-12(c)(3) in combination with I.R.C. § 108(e)(10)(A) produces the following result: If [redacted] issued the LYON to pay $[redacted] at maturity for $[redacted] and claimed $[redacted] in OID deductions up to the date of conversion, and the LYON holder received [redacted] shares of [redacted] stock then worth $[redacted], [redacted] would not have cancellation of indebtedness income on the conversion. However, if stock issued on conversion was worth less than $[redacted], [redacted] would have recognized income on conversion equal to the difference between $[redacted] and the fair market value of the stock issued. Since the Service has determined that the share value of [redacted] on conversion exceeded the amount paid plus accrued OID, [redacted] properly deducted accrued OID and did not suffer cancellation of indebtedness income on conversion of the LYONS.

This document may include confidential information subject to the attorney-client and deliberative process privileges, and may also have been prepared in anticipation of litigation. This document should not be disclosed to anyone outside the IRS, including the taxpayer(s) involved, and its use within the

IRS should be limited to those with a need to review the document in relation to the subject matter or case discussed herein.

This document also is tax information of the instant taxpayer that is subject to I.R.C. § 6103.

DANIEL J. WILES

By: Richard L. Carlisle
RICHARD L. CARLISLE
Chief, Financial Institutions
and Products Branch
Field Service Division